

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:LM:RFP:SLATL  
TL-N-2495-01

**date:** May 31, 2001

**to:** Terrance L. Dawson, Team Manager, LMSB  
Charlotte, North Carolina

Attn: Henry V. Harmon, Team Coordinator, John Crider and  
Nancy Armstrong, Team Members

**from:** Associate Area Counsel LMSB, CC:LM:RFP:SLATL

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**subject:** [REDACTED] - Taxable years [REDACTED]

This Advisory Opinion responds to your memorandums dated April 10 and April 17, 2001. **This memorandum should not be cited as precedent.**

**ISSUES**

With respect to the lease-in lease-out ("LILO") transaction between [REDACTED] and [REDACTED] whether [REDACTED] is entitled to deductions under I.R.C. §§ 162 and 467 with respect to lease payments incurred and whether interest deductions were allowable under I.R.C. § 163 in connection with the nonrecourse loan incurred to prepay the lease payments under the LILO.

You included an additional list of questions, concerns and comments by the Examination Team in connection with this transaction.<sup>1</sup>

You forwarded a complete set of documents, including the operative documents of the LILO (four volumes), [REDACTED] appraisals (two binders) and the Agent's Workbook (two binders) containing various analyses, schedules and computations including the in-house economist report.

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<sup>1</sup> We have not addressed those comments or concerns here. We do not believe those comments or concerns affect the conclusions reached in this Advisory.

**FACTS<sup>2</sup>**

On [REDACTED], acting through a Trust<sup>3</sup> it created, entered into a Head Lease Agreement for an undivided interest in the "gas networks" of [REDACTED], a public limited liability company organized under the laws of the [REDACTED].<sup>4</sup> [REDACTED] is owned by various [REDACTED], as a result of a merger among [REDACTED] energy companies in the [REDACTED] of [REDACTED] on [REDACTED]. [REDACTED] primary activities include the purchase and sale of energy (gas, electricity and heat) and the transportation and distribution of energy.<sup>5</sup>

The gas networks are described as (1) all distribution, transportation and service piping from the shut-off valves of the main reduction stations which connect [REDACTED]<sup>6</sup> to the networks, to the outlet of the gas meters installed in the customer's dwellings; and, (2) all receiving stations, main division stations, main reduction/transfer stations, delivery stations, customer gas reduction installation, meters, valves and other parts required for the control, measurement and distribution of natural gas in the networks.<sup>7</sup>

[REDACTED], through its Trust, entered into a Head Lease with [REDACTED] under which [REDACTED] leased a [REDACTED] percent undivided interest in the [REDACTED] gas network for a period of [REDACTED] years.<sup>8</sup> An

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<sup>2</sup> The facts are taken from the April 17, 2001 write-up by John Crider. We have examined the supporting documentation and are satisfied that the representations of fact made and the conclusion drawn are accurate.

<sup>3</sup> Any reference in this document to [REDACTED] includes the Trust.

<sup>4</sup> Head lease Agreement - [REDACTED]

<sup>5</sup> Agent's Workbook, [REDACTED]

<sup>6</sup> [REDACTED], a [REDACTED] entity engaged in the business of trading and carrying natural gas

<sup>7</sup> Appraisal Report - [REDACTED]

<sup>8</sup> The Head Lease defines the Lease Term as merely commencing on the date of the lease ([REDACTED]) and ending on the "Termination Date." [REDACTED] to the Sublease Agreement, [REDACTED] provides the applicable lease term dates and these are

unrelated party leased the balance of the undivided interest in the gas network as of the same date. Simultaneously [REDACTED] through its Trust entered into a Sublease Agreement with [REDACTED] for the exact same [REDACTED] percent undivided interest in the gas network. The Sublease was for [REDACTED] years with a Renewal Period of an additional [REDACTED] years.<sup>9</sup>

The [REDACTED] percent interest was valued by Deloitte & Touche as having a fair market value of \$ [REDACTED] at the time of the closing date of the Lease Agreement.<sup>10</sup>

Under the Head Lease, [REDACTED] was required to make an Advance Rent Payment of \$ [REDACTED] to [REDACTED] on the closing date and to make a Deferred Rent Payment due [REDACTED] years after the expiration of the Head Lease.<sup>11</sup> To fund the Advance Rent Payment under the Head Lease, [REDACTED] made an equity contribution from its own funds of \$ [REDACTED] and borrowed the remainder, \$ [REDACTED] from [REDACTED] in the form of a nonrecourse loan.<sup>12</sup> [REDACTED] paid transaction fees of \$ [REDACTED] from its own funds.<sup>13</sup>

The nonrecourse loan is effective [REDACTED] and has a maturity date of [REDACTED]<sup>14</sup> which makes the term of the nonrecourse loan [REDACTED] years, [REDACTED] months. This term is slightly in excess of the combined terms of the Sublease and the Renewal Period of [REDACTED] years ([REDACTED] years plus [REDACTED] years).

[REDACTED] was protected from risk of loss with respect to its initial investment of funds because [REDACTED] was required to maintain a letter of credit in favor of [REDACTED] for the aggregate amount of

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corroborated in the Transaction Summary detailed in the Agent's Workbook, [REDACTED]

<sup>9</sup> Transaction Summary, Agent's Workbook, [REDACTED]  
[REDACTED]

<sup>10</sup> Appraisal Report - [REDACTED]

<sup>11</sup> Lease Agreement - [REDACTED]

<sup>12</sup> Participation Agreement - [REDACTED]  
[REDACTED]

<sup>13</sup> Id. [REDACTED]

<sup>14</sup> Loan and Security Agreement, [REDACTED]  
[REDACTED]

obligations of [REDACTED] to [REDACTED]<sup>15</sup> under all of the operative documents.<sup>16</sup> The cost of [REDACTED]'s obtaining the letter of credit was borne by [REDACTED].<sup>17</sup>

The advance rent payment and the deferred rent payment are determined based on a percentage of the fair market value of [REDACTED]'s undivided interest in the underlying equipment cost of the leasehold.<sup>18</sup>

The Sublease Agreement provides a schedule of rent payments in both the initial term and in the renewal period in amounts expressed as a percentage of the fair market value of [REDACTED]'s undivided interest in the underlying equipment cost of the leasehold.<sup>19</sup>

On the closing date of the transaction, several related actions were taken by various parties to the transaction. (1) On receipt of the Advance Rent, [REDACTED] the Lessor-Sublessee was required to transfer \$[REDACTED] an amount equal to the nonrecourse loan obtained by [REDACTED] from [REDACTED] to the Payment Undertaking Party. The Payment Undertaking Party is also [REDACTED].

Under the Payment Undertaking Agreement between [REDACTED] and [REDACTED], [REDACTED] assigned its interest in the Payment Undertaking Agreement to [REDACTED] which in turn obtained a security interest in that interest as security for the nonrecourse loan made by [REDACTED] to [REDACTED].<sup>20</sup> In essence, upon deposit of the \$[REDACTED] by [REDACTED] with [REDACTED], the \$[REDACTED] was to become the asset of the Payment Undertaking Party ([REDACTED]) and was to cease to be an asset of [REDACTED].<sup>21</sup>

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<sup>15</sup> Participation Agreement - [REDACTED]

<sup>16</sup> Participation Agreement - [REDACTED]

<sup>17</sup> Response to IDR # [REDACTED], Agent's Workbook, [REDACTED]

<sup>18</sup> Head Lease - [REDACTED]

<sup>19</sup> Sublease - [REDACTED]

<sup>20</sup> Payment Undertaking Agreement - [REDACTED]

<sup>21</sup> Payment Undertaking Agreement - [REDACTED]

The \$ [REDACTED] was to be used by the Payment Undertaking Party to make payments required by [REDACTED] to [REDACTED] under the Sublease or to the lender of Sublessor's ([REDACTED]'s) nonrecourse loan.<sup>22</sup> Under the Debt Undertaking Agreement the deposit of the \$ [REDACTED] earns an investment rate equal to the rate on the nonrecourse loan and at all times equals the outstanding principal amount of the nonrecourse loan.<sup>23</sup>

On the closing date [REDACTED] the Lessor/Sublessee, was required to deposit \$ [REDACTED] of the amount it received under the Advanced Rent Payment to an [REDACTED].<sup>24</sup> The [REDACTED] was created to be a custodian of the funds and was to act as required by the party signatories to the operative documents of the Participation Agreement, the same parties to the LILO transaction. The deposit of \$ [REDACTED] became a part of the estate of the [REDACTED] and ceased to be an asset of either [REDACTED] or [REDACTED].<sup>25</sup> Under the Equity Payment Undertaking Agreement, the [REDACTED] was required to invest the \$ [REDACTED] in U.S. securities and to pay to the Trustee as Sublessor, and the Investor [REDACTED] for the benefit of the Sublessee or the [REDACTED] as the case may be, amounts equal to the Sublessee's obligations as and when such obligations must be paid pursuant to their terms.<sup>26</sup> Those obligations included the equity portion of the Sublease Basic Rent, the Sublease Renewal Term Basic Rent, the Sublease Purchase Option Price, the Sublease Termination Value, the Sublease Special Termination Value, the Burdensome Buyout Value, and any other payments to be made under section [REDACTED] or [REDACTED] of the Sublease which are due and owing by [REDACTED].<sup>27</sup>

The balance of the funds paid to [REDACTED] or \$ [REDACTED] (\$ [REDACTED] minus \$ [REDACTED] minus \$ [REDACTED]) were retained

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<sup>22</sup> Id. Sections [REDACTED] & [REDACTED]

<sup>23</sup> Transaction summary - [REDACTED] Agent's Workbook

<sup>24</sup> Equity Payment Undertaking Agreement - Sections [REDACTED] & [REDACTED]  
[REDACTED]

<sup>25</sup> Id., Section [REDACTED]

<sup>26</sup> Equity Payment Undertaking Agreement - Section [REDACTED]  
[REDACTED]

<sup>27</sup> Id. Definitions, "Sublessee Obligations"

by [REDACTED] as its fee for participation in the transaction. This fee represents the net present value of the tax benefits to [REDACTED]<sup>28</sup>

[REDACTED] received a fee of \$ [REDACTED] on the closing of the [REDACTED] lease on [REDACTED]. The fee was paid through [REDACTED] by [REDACTED]. The fee resulted from an oral contract between [REDACTED] and the payor for advisory services contingent on a successful closing of the deal. The fee was set at [REDACTED] percent of asset value.

The Sublease Agreement between [REDACTED] and [REDACTED] provided different options for both [REDACTED] and [REDACTED]. At the end of the basic term, [REDACTED] could purchase [REDACTED]'s residual interest in the Head Lease (the Early Buyout Option), at the "EBO" price;<sup>29</sup> . Under this option, in addition to payment of the EBO price, [REDACTED] assumes [REDACTED]'s Deferred Rent obligation under the Head Lease. (At this point [REDACTED] owes the Deferred Rent to itself and [REDACTED]'s obligation is considered satisfied).

If [REDACTED] does not exercise the EBO, [REDACTED] has three options: (1) to require [REDACTED] to renew the Sublease for the Replacement Sublease Term ([REDACTED]) years; (2) to find a third party to sublease the Equipment at then prevailing market rents for the Sublease Renewal Term ([REDACTED]) years; or (3) to require the Sublessee to deliver the undivided interest in the [REDACTED] to the Sublessor (the Return Option).<sup>30</sup>

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<sup>28</sup> Participation Agreement - Definitions - [REDACTED]

<sup>29</sup> Sections [REDACTED] The EBO price is defined in the Sublease Agreement - Section [REDACTED] as being equal to the amount of the funds in the Equity Defeasance Account plus the outstanding balance on [REDACTED]'s nonrecourse loan plus any pro rata rent that is due. The EBO Purchase Price is not paid in its entirety on the EBO date but rather is paid in installments during the following year.

<sup>30</sup> Sublease Agreement - Section [REDACTED] The Lease Transaction Summary, Agent's Workbook [REDACTED] refers to returning the equipment to the investor whereas [REDACTED] according to the Head Lease, owns an undivided interest in the gas networks which is comprised of various equipment.

If [REDACTED] (the Sublessee) is required to lease the equipment for the renewal period, the rent payments increase significantly relative to the rents due under the basic term of the Sublease.<sup>31</sup>

Under either option (1) or (2), in the event of non exercise of the EBO, the Head Lease Deferred Rent obligation of [REDACTED] is ultimately offset by the Sublease Renewal or Replacement Sublease rents plus an implied interest rate. At the beginning of the Sublease Renewal Term, [REDACTED] pledges the Sublease Renewal Rents as collateral for its payment of the Deferred Rent. The pledged rents grow at a predetermined rate so that by the time the Deferred Rent becomes due, the value of the Sublease renewal rents is equal to the Deferred Rent. In effect, this obligation is fulfilled with no additional funding requirement on the part of [REDACTED].<sup>32</sup>

Under option (3), [REDACTED] continues to hold title to the Equipment but would have no further interest other than its reversionary interest at the expiration of the Head Lease.<sup>33</sup>

If the EBO has not been exercised and if the nonrecourse loan has not been paid in full at that time, the Sublessee is required to arrange for a loan extension and if third party lenders cannot be arranged for [REDACTED] percent of the outstanding loan balance, the Sublessee shall purchase up to [REDACTED] percent of the loan certificates for which such third party lenders cannot be arranged.

Regarding the various options available at the end of the Sublease Basic Lease Term, the Appraisal Report concluded:

(1) No material economic inducement exists to [REDACTED] to exercise its Purchase Option;<sup>34</sup>

(2) [REDACTED] is not under any economic compulsion to exercise the Purchase Option and that [REDACTED] will be more likely to return the Undivided Interest in such network to [REDACTED] than exercise the Purchase Option under the Sublease;<sup>35</sup>

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<sup>31</sup> Sublease Agreement - [REDACTED]

<sup>32</sup> Transaction Summary, Agent's Workbook, [REDACTED]

<sup>33</sup> Sublease Agreement - [REDACTED]

<sup>34</sup> Appraisal Report, Letter from Deloitte & Touche dated [REDACTED] of the Report

<sup>35</sup> Id. [REDACTED] of the Report

(3) It is reasonable to conclude that [REDACTED] is more likely to provide a third party Replacement Sublessee than it is to exercise its renewal option and therefore it is not expected that [REDACTED] would renew the Sublease;<sup>36</sup> and,

(4) It is reasonable to expect that it will be economically and commercially feasible for the Undivided Interest to be sold or leased to a person other than [REDACTED] at the end of the Lease Term, or at the end of the Sublease Basic Term and that such purchaser or lessee would be able to operate the Network under commercially reasonable terms.<sup>37</sup>

The internal IRS Economist's Report concluded this LILLO transaction was not commercially feasible for [REDACTED] without the tax benefits associated with it.<sup>38</sup> He calculated the pre-tax return to [REDACTED] as between [REDACTED] percent and [REDACTED] percent depending on whether or not the EBO option was exercised. The post-tax return was calculated to be between [REDACTED] percent and [REDACTED] percent.<sup>39</sup>

[REDACTED]'s reporting of the transaction for federal income tax purposes was as follows<sup>40</sup>

(1) Rental income received was reported as income.

(2) The implied interest earned on the Deferred Rent would be reported as income.

(3) The \$ [REDACTED] Head Lease Rent is to be deducted over the first [REDACTED] years of the Head Lease as set forth in the Head Lease Schedule.

(4) If the EBO were exercised, no Deferred Rent payment would be due. Therefore the previous deductions taken prior to the EBO Purchase Date would be reported as income.

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<sup>36</sup> Id. Item [REDACTED]

<sup>37</sup> Id. Items [REDACTED]

<sup>38</sup> Agent's Workbook, [REDACTED]

<sup>39</sup> Id. [REDACTED]

<sup>40</sup> Tax Return - See excerpts in Agent's Workbook - [REDACTED]  
Transaction Analysis - [REDACTED]

(5) The Deferred Rent amount is being deducted based on a present value of the allocated rents at [REDACTED] percent of the AFR rate and a deduction is taken for the implied interest on the discounted accrued but unpaid rent.

(6) Fees and expenses paid at closing are amortized [REDACTED] over the initial Sublease Term and [REDACTED] over the total Sublease Term.

## CONCLUSION

The LILO transaction lacks economic substance and should not be respected for federal income tax purposes. Accordingly, the deductions taken by [REDACTED] under I.R.C. §§ 162 and 467 with respect to lease payments incurred and the interest deductions taken by [REDACTED] pursuant to I.R.C. § 163 in connection with the nonrecourse loan incurred to prepay the lease payments under the LILO should be disallowed.

## LAW AND ANALYSIS

### 1. Economic Substance

To be respected, a transaction must have economic substance separate and distinct from the economic benefit achieved solely by tax reduction. If a taxpayer seeks to claim tax benefits, which were not intended by Congress, by means of transactions that serve no economic purpose other than tax savings, the doctrine of economic substance is applicable. United States v. Wexler, 31 F.3d 117, 132, 124 (3d Cir. 1994); Yosha v. Commissioner, 861 F. 2d 494, 498-499 (7<sup>th</sup> Cir. 1988), aff'g Glass v. Commissioner, 87 T.C. 1087 (1986); Goldstein v. Commissioner, 364 F.2d 734 (2<sup>nd</sup> Cir. 1966), aff'g 44 T.C. 284 (1965); Weller v. Commissioner, 31 T.C. 33 (1958), aff'd, 270 F.2d 294 (3d Cir. 1959); ACM Partnership v. Commissioner, T.C. Memo. 1997-115, aff'd in part and rev'd in part, 157 F.3d 231 (3d Cir. 1998).

Whether a transaction has economic substance is a factual determination. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 456 (1950). This determination turns on whether the transaction is rationally related to a useful non-tax purpose that is plausible in light of taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. The utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with

commercial practices in the relevant industry. Cherin v. Commissioner, 89 T.C. 986 993-94 (1987); ACM Partnership, supra. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the non-tax benefits would be at least commensurate with the transaction costs. Yosha, supra; ACM Partnership, supra.

In determining whether a transaction has economic substance so as to be respected for tax purposes, both the objective economic substance of the transaction and the subjective business motivation must be determined. ACM Partnership, 157 F.3d at 247; Horn v. Commissioner, 968 F. 2d 1229, 1237 (D.C.Cir. 1992), Casebeer v. Commissioner, 909 F.2d 1363 (9<sup>th</sup> Cir.1990). The two inquiries are not separate prongs, but are interrelated factors used to analyze whether the transaction had sufficient substance apart from its tax consequences, to be respected for tax purposes. ACM Partnership, 157 F.3d at 247; Casebeer, 909 F.2d at 1363.

Courts have recognized that offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of the transaction. Knetsch v. United States, 364 U.S. 361 (1960). In Knetsch, the taxpayer repeatedly borrowed against increases in the cash value of a bond. Thus the bond and the taxpayer's loans constituted offsetting obligations. As a result, the taxpayer could never derive any significant benefit from the bond. The Supreme Court found the transaction to be a sham, as it produced no significant economic effect and had been structured only to provide the taxpayer with interest deductions.

In Sheldon v. Commissioner, 94 T.C. 738 (1990), the Tax Court denied the taxpayer the tax benefits of a series of Treasury bill sale-repurchase transactions because they lacked economic substance. In the transactions, the taxpayer bought Treasury bills that matured shortly after the end of the tax year and funded the purchase by borrowing against the Treasury bills. The taxpayer accrued the majority of its interest deduction on the borrowings in the first year while deferring the inclusion of its economically offsetting interest income from the Treasury bills untio the second year. The transactions lacked economic substance because the economic consequence of holding the Treasury bills was largely offset by the economic cost of the borrowings. The taxpayer was denied the tax benefit of the transactions because the real economic impact of the transactions was "infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions." Sheldon, 94 T.C. at 768.

In ACM Partnership v. Commissioner, 157 F.3d 231 (3<sup>rd</sup> Cir. 1998) the taxpayer entered into a nearly simultaneous purchase

and sale of debt instruments. Taken together, the purchase and sale "had only nominal, incidental effects on [the taxpayer's] net economic position." ACM Partnership, 157 F.3d at 250. The taxpayer claimed that, despite the minimal net economic effect, the transaction had economic substance. The court held that the transactions that do not "appreciably" affect a taxpayer's beneficial interest, except to reduce tax, are devoid of substance and are not respected for tax purposes. ACM Partnership, 157 F.3d at 248. The court denied the taxpayer the purported tax benefits of the transaction because the transaction lacked any significant economic consequences other than the creation of tax benefits.

In other leasing transactions, leases have been respected despite the presence of credit support for their payment, such as third-party rent guarantees. See Torres v. Commissioner, 88 T.C. 702 (1997); Cooper v. Commissioner, 88 T.C. 84 (1987); Gefen v. Commissioner, 87 T.C. 1471 (1986). On the other hand, a fully defeased lease arguably is not "compelled or encouraged by business and regulatory realities" as required by Frank Lyon v. Commissioner, 435 U.S. 561, 583 (1978).

Moreover, claims of pre-tax profit are not dispositive. There is some precedent that economic substance for a lease transaction will be satisfied if there is "some modicum" of economic substance, which may mean "some modicum" of pre-tax profit. See Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184 203 n.17 (1983) aff'd in part and rev'd in part on other grounds., 752 E.2d 89 (4<sup>th</sup> Cir. 1985). See Estate of Thomas v. Commissioner, 84 T.C. 412, 440 n.52 (1985). In Hines v. Commissioner, 912 F.2d 736 (4<sup>th</sup> Cir. 1990) the Fourth Circuit found that a leasing transaction was a sham. In doing so, it described a \$17,000 profit potential as "minimal" on an eight-year investment of \$130,000. The court found evidence of tax motivation in the offsetting obligation to pay rent and debt service. The transaction also involved the use of related parties to avoid section 465. Under these facts, the court found that "the tax tail began to wag the dog." Hines, 912 F.2d at 741. Thus, small profits on a lease transaction may be overlooked when tax considerations have taken over the transactions. See also Pacheco v. Commissioner, T.C. Memo 1989-296.

## 2. Application to LILO Transaction

A LILO transaction that lacks economic substance will be recharacterized for federal income tax purposes based on the substance of the transaction. Rev. Rul. 99-14, 1999-13, I.R.B. 3, citing Gregory v. Helvering, 293 U.S. 495 (1935).

Under the facts of this transaction, it is our view that the transaction lacks economic substance because the transaction lacks the potential for any significant economic consequences other than the creation of the tax benefits.

The flow of funds, including the loan by [REDACTED] to [REDACTED], the payment by [REDACTED] to [REDACTED] under the Head Lease, the payments by [REDACTED] under the Sublease and the payments by [REDACTED] under the nonrecourse loan represent a circular cash flow. [REDACTED] borrows from [REDACTED], which send the funds to [REDACTED], which in turn deposits the funds at [REDACTED]. [REDACTED] then makes payments on behalf of [REDACTED] (to [REDACTED] equal to the obligation of [REDACTED] to [REDACTED] under the Sublease. [REDACTED] then takes the funds received on behalf of [REDACTED] from [REDACTED] and pays the obligation of [REDACTED] to itself under the nonrecourse loan.

[REDACTED]'s rights under the Payment Undertaking Agreement are assigned to [REDACTED] as security for the nonrecourse loan obtained by [REDACTED] from [REDACTED]. The Payment Undertaking Agreement provides no additional security to [REDACTED] in connection with the nonrecourse loan. [REDACTED] already has a security interest in the Head Lease and the Sublease.

Although neither [REDACTED] nor [REDACTED] has a right of set off against any payments for amounts not received,<sup>41</sup> the economic reality is that all amounts are, at all times, under the control of [REDACTED] and are being used to fund the payments of [REDACTED] to [REDACTED] under the Sublease and the payments of [REDACTED] to [REDACTED] under the nonrecourse loan. So, [REDACTED] is paying to itself amounts due under the nonrecourse loan. This belies any contention that [REDACTED] is at risk for amounts loaned to [REDACTED].

Also, there is little or no financial exposure to [REDACTED]. [REDACTED] was protected from risk of loss with respect to its initial investment of funds because [REDACTED] was required to maintain a letter of credit in favor of [REDACTED] for the aggregate amount of obligations of [REDACTED] to [REDACTED]<sup>42</sup> under all of the operative documents. On the closing date [REDACTED], the Lessor/Sublessee, was required to deposit \$[REDACTED] of the amount it received under

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<sup>41</sup> Payment Undertaking Agreement - Section [REDACTED]  
[REDACTED]

<sup>42</sup> Participation Agreement - Section [REDACTED]  
[REDACTED]

the advanced rent payment to an [REDACTED].<sup>43</sup> The [REDACTED] was created to be a custodian of the funds and was to act as required by the party signatories to the operative documents of the Participation Agreement, the same parties to the LILLO transaction.

The deposit of \$[REDACTED] became a part of the estate of the [REDACTED] and ceased to be an asset of either [REDACTED] or [REDACTED].<sup>44</sup> Under the Equity Payment Undertaking Agreement, the [REDACTED] was required to invest the \$[REDACTED] in U.S. securities and to pay to the Trustee as Sublessor, and the Investor ([REDACTED]) for the benefit of the Sublessee or the [REDACTED], as the case may be, amounts equal to the Sublessee's obligations as and when such obligations must be paid pursuant their terms.<sup>45</sup> Those obligations included the equity portion of the Sublease Basic Rent, the Sublease Renewal Term Basic Rent, the Sublease Purchase Option Price, the Sublease Termination Value, the Sublease Special Termination Value, the Burdensome Buyout Value, and any other payments to be made under section [REDACTED], [REDACTED] or [REDACTED] of the Sublease which are due and owing by [REDACTED]. Effectively, all of the obligations of [REDACTED] to [REDACTED] were defeased through this arrangement.

The different options presented to [REDACTED] at the end of the Sublease do not present real economic risk to [REDACTED]. As you note in your analysis on page [REDACTED], if the EBO is exercised, [REDACTED] purchases [REDACTED]'s interest in the Head Lease at the predetermined price set as of [REDACTED], the closing date of the transaction. The EBO purchase price is equal to the amount of funds in the [REDACTED] plus the outstanding balance owed on [REDACTED]'s nonrecourse loan to [REDACTED]. [REDACTED]'s Deferred Rent obligation under the Head Lease disappears. The fact is that under this option, neither party to the transaction is required to pay any additional funds.

If the EBO is not exercised, [REDACTED] has three options: (1) to require [REDACTED] to renew the Sublease for the Replacement Sublease Term ([REDACTED]) years; (2) to find a third party to sublease the Equipment at then prevailing market rents for the Sublease Renewal Term ([REDACTED]) years; or (3) to require the Sublessee to

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<sup>43</sup> Equity Payment Undertaking Agreement - Sections [REDACTED]

<sup>44</sup> Id., Section [REDACTED]

<sup>45</sup> Equity Payment Undertaking Agreement - Section [REDACTED]

deliver the undivided interest in the Gas Network to the Sublessor (the Return Option).

Under the first two alternatives [REDACTED]'s obligation for the Deferred Rent is offset by the Sublease Renewal Period Rents or Replacement Rents plus an implied interest rate. At the beginning of the Sublease Renewal Term, [REDACTED] pledges the Sublease Renewal Rents as collateral for its payment of the Deferred Rent. The pledged rents grow at a predetermined rate so that by the time the Deferred Rent becomes due, the value of the Sublease Renewal Rents is equal to the Deferred Rent. In effect this obligation is fulfilled with no additional funding requirement on [REDACTED]'s part.<sup>46</sup>

In making a decision not to exercise the EBO, one factor that [REDACTED] must consider from an economic viewpoint is the fact that [REDACTED] could force [REDACTED] to accept the sublease renewal which would result in their having to pay significantly higher rents during the Sublease Renewal period.<sup>47</sup> Since this would require annual cash outlays not required under the EBO option, it would seem to render the Sublease Renewal an unlikely event. This is opposite to the conclusion reached in the Deloitte & Touche Appraisal that "the Sublessee would not be under any economic compulsion to exercise the EBO purchase."<sup>48</sup>

For the same reasons, the likelihood of finding a Third-Party sublessee as opposed to the EBO being exercised is unlikely. And the ability to find a substitute lessee is questionable, notwithstanding the opinion of Deloitte & Touche.

Based on the above, it is reasonable to conclude the EBO will be exercised by [REDACTED] because the purchase option payment is fully defeased and it will cost nothing to [REDACTED] to exercise this option. Also, [REDACTED] is the owner-operator of the gas networks, has continued to be so under the Sublease, and exercising the EBO

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<sup>46</sup> Transaction Summary, Agent's Workbook, [REDACTED]

<sup>47</sup> Sublease Agreement - [REDACTED]

<sup>48</sup> Appraisal Report, [REDACTED] Arguably these significantly higher rents seem to imply a higher fair market value for the leased equipment. If the fair market value of the equipment were higher at the end of the Head Lease, it would seem to make more economic sense for the EBO to be exercised. While we have not performed a valuation of the leased equipment, we note this fact calls into question the conclusion reached by Deloitte & Touche that the equipment is worth appreciably less at the end of the Head Lease Term.


will merely return the parties to their respective positions existing prior to the transaction date.

Accordingly, under the principles of Rev. Rul. 99-14 and the legal and factual analysis, above, we conclude the LILO lacks economic substance and should not be given effect for federal income tax purposes. No deductions for expenses arising out of the transaction including the Advanced Rents are deductible by [REDACTED] under I.R.C. §§ 162 and 467. And no interest deduction is permissible under I.R.C. § 163 with respect to interest paid by [REDACTED] to [REDACTED] with respect to the nonrecourse loan.

Please do not hesitate to contact the undersigned at (404)338-7852 if we can be of further assistance.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Associate Area Counsel (LMSB), Atlanta

by:   
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Special Litigation Attorney